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PROPOSITION 13 AND OTHER TAX SYSTEM CONSEQUENCES

A recent Field poll of California citizens indicated substantial majorities had a positive view of Proposition 13, the law that severely limits property tax increases except when real estate changes hands.

This poll was like asking people if they would like to see their taxes increase, without pointing out what the additional government revenue might be used for, or what the unintended consequences of Proposition 13 have been. For example, no mention was made of the fact that California now spends less than half of the amount per pupil on its public schools than New Jersey. California public schools generally have serious problems, including an unacceptable drop-out rate. The shortfall in funding can be traced largely to Proposition 13.

The great resulting tax disparity can be found locally in an upper-middle class neighborhood here in Northern California. On a West Valley dead-end cul-de-sac sits eleven homes. Six families are pre-Proposition 13 taxpayers who pay a total of \$14,200 worth of annual property taxes. The other five pay \$125,000. The average age of six original owners is 77, whereas the other five is age 50.

Most people are unaware that, in addition to protecting single-family residential property from sharp property tax increases, Proposition 13 also shelters industrial and commercial property. In general, property owned by a corporation or partnership will not be reassessed until more than 50 percent of the ownership of the corporation or partnership changes hands. Careful planning can avoid such ownership changes for many decades, even after some of the shareholders or partners die. That means, for example, property owned by PG&E prior to Proposition 13 will essentially never be reassessed, since no one person or entity is likely to ever gain control of PG&E by owning more than 50 percent of its stock.

Proposition 13 has caused a steady shift of the property tax burden from commercial and industrial property to residential property. Commercial and industrial property is even more likely than residential property to be locked into pre-Prop 13 assessments.

Seniors who want to move to a smaller, less expensive home generally face a steep increase in property taxes, which causes them to stay where they are. This locks in outdated assessments, thus denying the community the additional tax revenues that would be paid by a new owner of their home. This works to the advantage of neither the elderly nor the community.

State and federal tax laws, when combined with Prop 13, additionally act to discourage millions of homeowners, especially seniors, from moving out of their homes. Homeowners are entitled to a \$250,000 per person exemption when they sell their home. However, on sales above that amount, they pay a 15 percent federal and a 9.3 percent state capital gains tax. Seniors pay that tax wherever they move, even to assisted living units, where there are often heavy up-front fees.

The death of a spouse also creates a disparity in tax treatment. While an elderly couple pays the full capital gains when they move, a surviving partner pays no capital gains tax on a sale following the death of his or her spouse. The home is reassessed on a “stepped up” basis. For example, take a home purchased for \$50,000 in 1965 and sold for \$2,500,000 in 2008: A current surviving spouse pays no tax while a couple selling would pay as much as \$400,000 to \$500,000, depending on improvements.

To the extent that seniors are aware of this step-up provision, it is an enormous additional disincentive to move. To the extent they are not, their ignorance creates a huge inequity. Assisted living facilities are full of the elderly who paid capital gains plus a large up front fee to get into a retirement home, then find themselves in a financially-vulnerable position.

We suggest three solutions to inequities caused by Proposition 13:

- Seniors over 65 should be allowed to move anywhere in California without paying increased property tax, as long as they are moving to a less expensive residence.
- Prop 13 protections should be gradually removed from commercial and industrial property, allowing our schools to be better funded and stopping the property tax burden from shifting to residences.
- Capital gains taxes should be completely removed for sale of a residence by seniors over 65.